RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

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May 23, DJIA 854.10; PTI 1156; A-D ratio –20.56
May 30, DJIA 850.85; PTI 1172; A-D ratio –20.39

JERKED AROUND: Strange words to start an investment report, but that's the way the American consumer feels today, and what the consumer feels and does is what's going to determine the future trend of the US economy (70% of GNP is accounted for by consumer spending).

For years the US consumer has watched as prices surged upwards, and during that time the consumer learned that the best way to deal with inflation was to "invest in it." That meant buying everything you could get your hands on, from homes to cars, from diamonds to gold. Then last year the US Government (spurred on by a collapsing dollar) decided that "inflation is the enemy." In the space of a few months interest rates were forced to record highs, credit availability was cut off, and Americans were told to "bite the bullet." Whereupon the trouble began. Chrysler toppled towards bankruptcy, the Hunt brothers' silver "empire" collapsed, auto sales plummeted, housing sales ground to a virtual halt, and two large banks slid to the edge of insolvency.

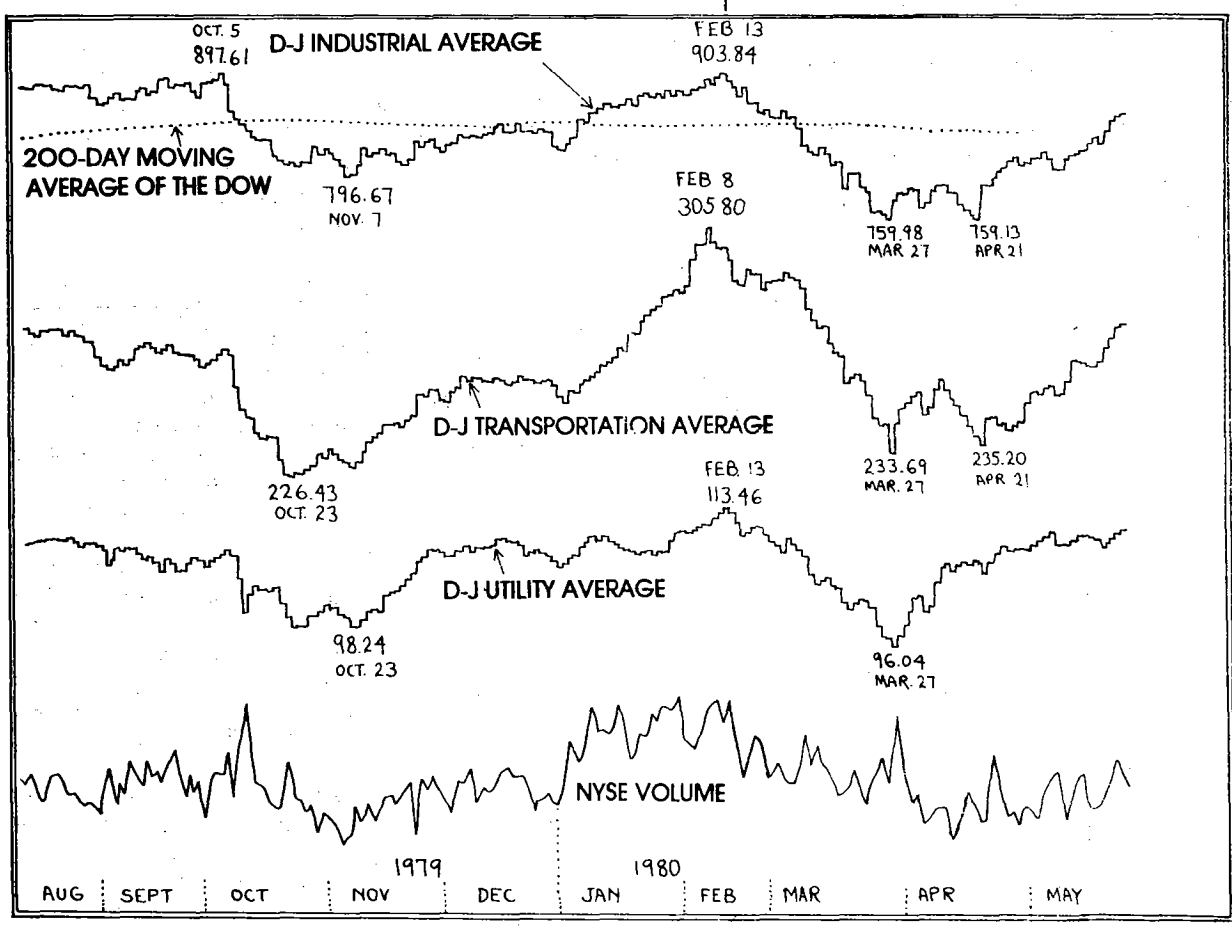
That was enough for the Fed. They had seen a month or two of recession and their reaction was, "Let's get rid of it, we've had enough, reverse the gears, the economy can't take it!" In the space of the next eight weeks the nation witnessed a swan dive by interest rates, numerous Fed bail-outs (Chrysler, Hunts, First National Bank of Chicago, First Pennsylvania Bank) a dismantling

FRONT PAGE COMMENT: The time span of economic events is now being telescoped. The pressures of rising debt and inflation are forcing ever-widening and ever more-rapid swings in the markets. It is possible, in fact, that bonds (rather than stocks) will be the major trading vehicles of the next few years. Already during 1979-80 we have seen bonds out-distance stocks in the swings as our Government forces interest rates first to record high levels, then allows them to drop to drastic lows.

As I see it there are just four ways the US can go: (1) towards hyper-inflation, (2) towards depression and deflation, (3) towards World War III, (4) to a dollar convertible into high-priced gold. Each of these "resolutions" would be difficult. In all but no. 2, it would pay the investor to hold gold.

"How about a fifth possibility," you ask, "How about stability?" My answer is that I don't think stability is in the cards, not at this late stage of the inflationary cycle. Our Government is trying to produce an "equilibrium effect" by swinging the economy between boom and recession. The results, unfortunately, are anything but stabilizing for the economy. Furthermore, the odds on a major MISTAKE (a miscalculation) by the Government are steadily increasing.

It is becoming patently clear that our Government is terrified of deflation. We can see this in the frantic monetary flip-flop by the Fed over the past month. Furthermore, it is clear (as I've said so many times before) that Americans have a definite *vested interest* in inflation. Americans are now heavily in debt, and they want to pay those debts off with "easy dollars." I would say that a period of three months of deflationary price action would send the entire US economy into collapse. And the Fed knows it.



of the restrictive credit policies and almost frantic comments from Mr. Miller and Mr. Carter to the effect that it was all right to dust off your credit cards and borrow your heads off again.

So the big question is: Can the consumer be jerked around by the Government at will? Can the American consumer be made to dance when the strings are pulled? We don't know the answer to that one yet, but one thing is certain—very certain. Washington has no stomach for pain, no stomach for recession. When it comes to a contest between inflation and deflation, it's clear which side Washington is sided on. Jobs, votes and inflation will win every time!

Over the past week I have read numerous treatises and reports by every kind of expert. The serious arguments break down into two camps. (1) Those who believe that the economy will hit bottom around the third quarter of 1980 (or thereabouts) to be followed by an even more virulent surge of inflation. (2) Those who believe that we have gone "over the edge" and are now headed into a gathering depression.

I want to be honest about this. I don't have a definite opinion about which camp is correct. But I do have a few thoughts of my own. (1) I think we are headed into times which will be progressively more volatile and more difficult. (2) I believe that the US standard of living is now in a long-term decline. (3) I believe the US has now PASSED the place where painless solutions to economic problems can be used (for instance, "mild " inflation). (4) I feel that we are moving ever closer to the time when Washington will lose control of the economy.

One of the phenomenons of the past few months has been the fantastic collapse in interest rates. Even bulls on the bond market (and I was one of them) can't believe the violence with which interest rates have caved in (they've certainly gone lower, faster than I thought they would). There are two explanations to the interest rate crash. One is that rates were pushed too high by the Fed, and thus when rates came down they also came down too far (action and reaction). The other explanation runs like this:

> Obviously, the greater the mountain of debt that is built up, the greater the forces of deflation. Therefore, the big question is—can the Fed continue to stave off the rising forces of deflation? No one knows the answer to that, but we do know one thing—the only way a debt-logged economy can avoid deflation is through more inflation. That, in a nutshell, is the great dilemma facing the US today.

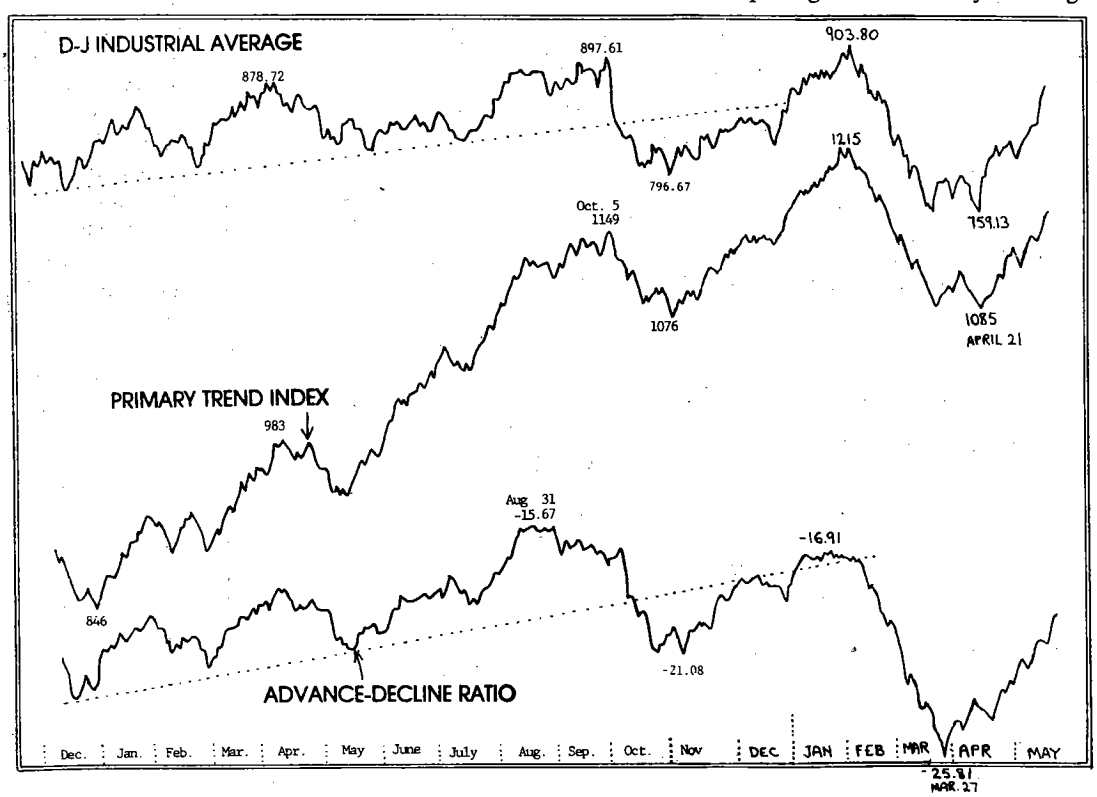
"Business must be in a free-fall; no one wants to borrow money. Thus, with liquidity 'coming out of our ears' interest rates have nowhere to go but down, down, down."

I don't know if either or both answers are correct, but I do know that somewhere ahead we are going to see a fat bounce upwards in rates. I say that because I am aware of the laws of physics (when a ball is dropped it bounces), and I also know that corporations and our Government are building up a perfectly massive bond calendar. Therefore, subscribers who have T-bills coming due should roll them over short (60-90 days), and wait for higher rates before going longer (up to 2-years) again.

Let's turn now to the stock market. The D-J Industrial Average (May 28) recovered roughly two-thirds of the ground lost during the February-March smash. The D-J Transports recouped a little better than 50% of its own February-March losses. The Utilities, the strongest of the three Averages during late-March and early-April (see page 1 chart) were flat all during May. (Even though interest rates have been dropping steadily).

There were no divergences near the May 28 highs (although the Utilities were dragging), and the market "appeared" strong but overbought. The real test always comes AFTER a decline, and on May 29 the first crack appeared as the Dow plunged over 14 points. If, after the post-May 28 weakness, the Averages can better previous highs (Industrials 860.32, Transports 271.20), the conclusion will be that the bulls are still in command.

Certain studies I follow suggest that the advance to the May 28 peak stemmed more from a cessation of selling pressures than from any powerful buying forces. This is confirmed by the surprising dearth of daily new highs on the advance and by the lack of any real market leadership (no important stock group came to the fore).



Turning to the daily chart of the Primary Trend Index (PTI) and the A-D ratio (at left), the picture is most interesting. It is clear that during the February-March decline, the A-D ratio was weakest, the Dow less weak and the PTI put in the best performance (the April 21 low on the PTI was above the October low). From the March-April lows the three indicators have rallied impressively, and on balance, half to two-thirds of the ground lost during February-March has been recovered by these indicators.

Back in Letter 780 I mentioned ("Front Page Comment") that my cycle for the Dow turned up in late-March and that this up-cycle would remain positive

until August. At that time I expected another very weak market as the whole 233-day cycle turned bearish. *Within* each previous 233-day cycle, however, there has been a correction during the 55 to 89 day period. We have entered that period, and a decline can now be expected (it evidently started on May 29). How severe (or mild) this decline is, will tell me much about the strength of this whole 233-day cycle. The KEY to the cycle, however, is whether the various stock averages can better their previous (February) peaks before this cycle expires in August. The previous cycle high on the Dow was 903.84, recorded on February 13.

X MARKS THE SPOT: Very few of us in these sophisticated modern times believe in omens. But I must admit that the spector of the exploding Mt. St. Helens spewing ashes and smoke across our Northwest gave me cause to wonder.

When the definitive history of the United States is written, I am reasonably convinced that two items will be blamed for our decline in power. The first is the deliberate policy of deficit spending and building of debts. Debt is like liquor; only the strong should use it, and then sparingly. Otherwise debt, like alcohol, ultimately takes on a life of its own and in due time destroys its master.

The second fateful item on my list is the Vietnam War. I firmly believe that the Vietnam war was a dagger in the chest of the US. It destroyed moral, it was in itself immoral, it caused the fall of a President, it practically bankrupted the nation. But worst of all, the war was fought on a tissue of deliberate lies and deceits. probably unmatched in US history. I felt at the time, and I still feel, that the Vietnam War somehow evolved from the worst elements in our nature, from stupidity and arrogance to callousness and hatred (the obsession with "body counts", I believe, was one of the grossest official procedures ever to come out of Washington). It was typical of this war that it was financed through deficits and inflation–it was totally unbudgeted.

But the story was being told from yet another arena. This was the arena of gold. For years I have been saying that the rise and fall of nations can be documented by their accumulation or loss of gold. When a nation loses its gold (whether through adverse balance-of-payments, through auctions, through panics or any other reason) that loss of gold is a definite sign of LOSS of power. The history of nations and empires, from Rome to Spain to Holland to England, can be written by their accumulation or loss of gold. Gold invariably leaves a nation that is falling from power. Conversely, gold goes towards nations that are gaining power.

When the US gold supply started to hemorrhage during the 1970's I wrote that this was an ominous sign of waning US power. If it continued, I wrote, it will spell the END OF US predominance in the world. Later, when the dollar caved in and the US auctioned off its gold in a vain attempt to force the price of gold down, I (along with many of my fellow "gold bugs") took this as an indication of US insanity. But the operative fact was that the US was losing its gold. The gold barometer was telling its story. US power was on the wane.

In recent months I have been talking specifically about the demise of US military power in comparison with Russian military power. The implications of this are becoming increasingly ominous. Consider this. Russia is a net exporter of oil now. But by the early 1980's Russia will be in equilibrium, and by the mid-1980's Russia will be a net importer of oil. Russia sits within easy striking distance of the greatest oil deposits in the world. Russia has already stationed masses of troops in Afghanistan. What happens next? I believe that the following intereview with "Mr. X" provides the answer.

Mr. X is an actual friend, a man I have known for 17 years. X's business, his living, is collecting, collating and analyzing facts gathered from military, industrial, government and other sources. I consider this particular interview as the most important of any I have published so far. In fact, I consider the Letter (because of the interview) to be one of the most important Letters (of any kind) that I have ever published.

X: I presume you saw the newspapers today (see clip). It's now official–the Carter Administration is going to spend LESS next year on defense than this year. You see, Carter told Europe and Japan, "Look, the US can't afford to be the lone bastian against the Soviets. We can't be the only Western military power. You've got to help, you've got to share the expenses." The result was–nothing. Europe and Japan looked the other way. So Carter figured, "Forget it, we'll have to accomodate the Russians, we'll work it out or something." So far, the script has worked out just the way I warned you that it would. The Russians are seizing every opportunity, probing every weakness. They're testing, testing.

Carter Plans Budget Fight, Aide Reports

President Will Seek Defense Cuts, More For Social Programs

New York Times News Service

WASHINGTON — President Carter has decided to oppose the proposed congressional budget of $813.3 billion for fiscal year 1981 because the administration says it devotes too much money to military spending and too little for jobs, cities, transportation and income security, a senior administration official announced yesterday.

The official, who made the announcement on the condition that he not be identified, said Mr. Carter hoped the House would reject the budget in a vote scheduled tomorrow and send it back to a House-Senate conference for reshaping. There was no suggestion that the overall spending figure be made larger or smaller, only that some of the money be shifted from military to other purposes.

Russell: There's no argument about that now. So what's on Carter's mind? Is he throwing in the sponge? It looks as though he's conceded that Russia is now so far ahead of us militarily that there's no sense in throwing in increased funds on a futile attempt to catch up.

X: I don't know what's on Carter's mind, but I do know that the Russians are pulling so far ahead of us militarily that there's literally no chance of our catching up–and the span is widening more and more. It's a very sad story. On land, at sea, in the air, Russia now has overwhelming superiority, and that superiority just keeps building.

Russell: What do you see as the next step?

X: I believe that the Russians are making an example of Afghanistan. I believe they are now in the process of decimating, actually wiping out Afghanistan. You see, we Americans are humane, but the Russians are cruel and very thorough. The Afghans are bothering the Russians, they are annoying them, standing in their way in that the Afghans are resisting. So the Russians are going to increase their troop strength in Afghanistan, probably bring in 4 or 5 more divisions. They will literally wipe the Afghans off the face of the earth. This is what Vietnam (under

Annual weapons production
(Average 1977-1979)
Source: U.S. Department of Defense

	U.S.	U.S.S.R.
Tanks	650	2,000
Combat planes	275	500
Helicopters	150	350
Major surface ships	10	10
Attack submarines	3	6
Other combat vehicles	1,000	5,000

S.F. Sunday Examiner & Chronicle

Russian auspices) has been doing to the Cambodians. The Afghans will go the same way. And of late we've said little or nothing about it; the news sources have "dried up." The Afghan thing will be a warning to the Mideast and the world, "Stand in the way of the Russians and you'll be annihilated." It will be a vivid and horrific lesson. The Arabs, by the way, will mark well what is happening to the Afghans.

Russell: What next?

X: I would say that within a year, probably less, the Russians will move into Iran. That will be the signal that the Mideast is in the grip of the Russian bear.

Russell: And what do you see us doing?

X: Nothing, or at the most **complaining** as we have complained about Cambodia, about the Iran hostages and about Cuba and Afghanistan. But I am convinced that the Administration has *already written off the Mideast oil*. I believe that Carter, in asking for still more military cutbacks, has ALREADY CONCEDED that the Mideast, and with it 50% of America's oil supply, is going to the Russians.

Russell: That's incredible. But you sound as though it's an accomplished fact. What odds would you give that the Russians will move into the Mideast?

X: I say 98% that they move. What's to stop them? Europe already sees the picture. The Western Alliance is now falling apart. Who followed Carter's plea to stay out of the Olympics? West Germany, and they're re-thinking their position. Europe senses the collapse of the US military umbrella, and they (along with Japan) are making their own deals. And they're prepared to deal with Russia for oil. The Russians, when they move into the Mideast, will probably supply the Europeans and Japan with oil because they're no threat. They'll cut the US out, and in so doing break up the alliance and create an "every man for himself" atmosphere.

Russell: When do you see all this happening?

X: As I said before, the Olympic games are important to Russia from a propaganda standpoint. Therefore, I see the Russians holding off until after the games. That means from August on we can expect trouble. Russia would probably prefer dealing with Carter, who is a known commodity (a "pussycat" and an accomodater) rather than Reagan who is an unknown quantity. This means that Russia could conceivably move before the November elections, particularly if Russia suspects a Reagan victory at the polls.

Russell: Well, if we lose the Mideast oil, we will lose half our oil supplies overnight. That would spell depression in the US, a collapse in energy availability. What do we as investors, as survivors–do?

X: Russell, that's your department. I'm just a military analyst. (End of interview).

At this point, as I see it now, subscribers will have to *diversify*, and there's no guarantee of anything except fear and chaos, if and when the Russians march into the Mideast. As matters stand now, you will need a definite position in gold coins, up to 20 to 25% of your assets. You would probably want to own some domestic or Canadian oil shares, companies such as Mesa Petroleum, Dome Petroleum, Superior Oil, American Quasar. But in the main, you should (besides gold coins) be liquid and ready to move, and that means Treasury bills and notes.

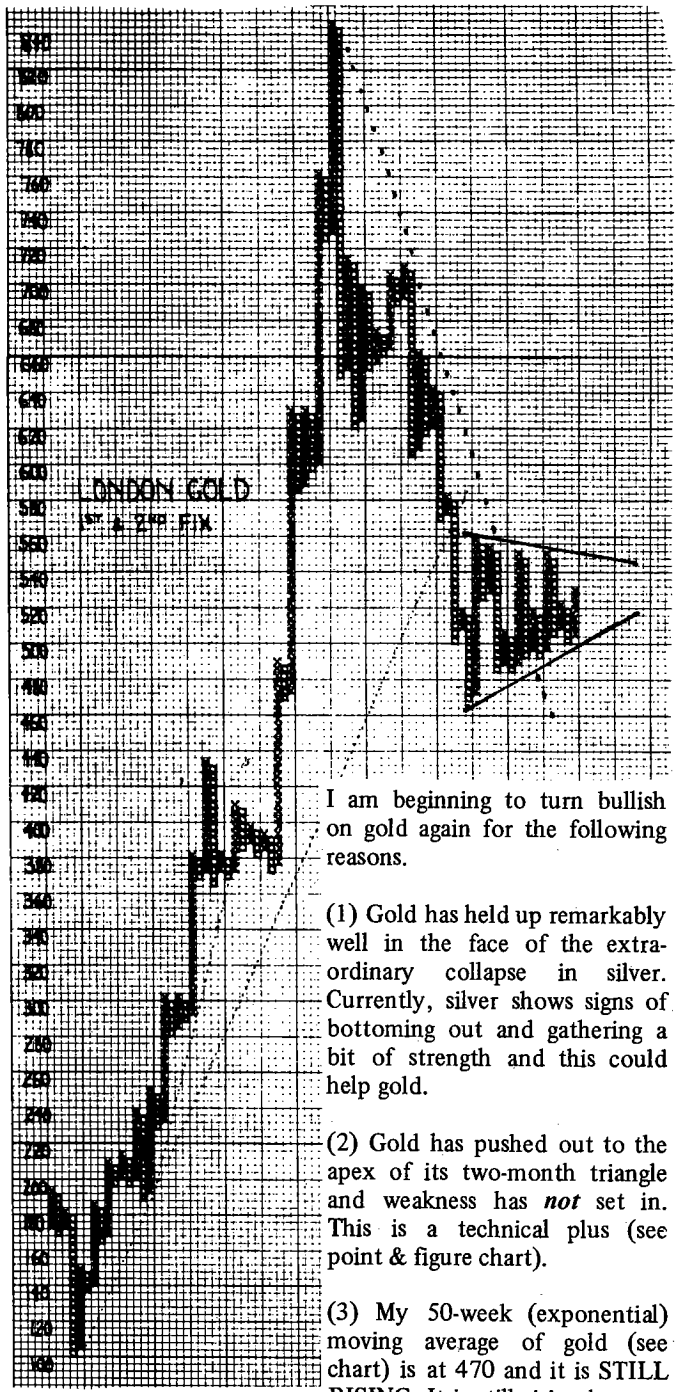
How a cut-off of oil would affect those who live in the big cities, in the cold climates, in the heavily populated areas I can only guess. All things being equal, I would say that if what I foresee comes to pass, the best state to live in would be Texas. They have oil, no state taxes and a long history of home protection and not taking nonsense. To my many Texas subscribers I say, "Sit tight, pardners, you're in the right spot at the right time."

GOLD: More inflation, deflation, which one is in the cards–and how will gold act given one or the other? If the US opts for a new round of inflation (pardon me, let's call it "re-stimulation of the economy"), gold is going to go up again. But the question is, will the new Government efforts at stimulation "take," will people start spending and borrowing again? We don't know the answer to that one–yet.

But what if the economy slides into collapse and deflation? If that occurs, the path of gold is less clear. On the one hand, true deflation would be bearish for gold on the face of it. But, deflation (if it occurs) would be sure to set off one of the greatest banking and bankruptcy crises this nation has ever seen. If deflation hits, the huge mountain of US debt (and the servicing requirements of that debt) would send consumers, corporations and the government into insolvency in a matter of months. The immediate result would be a panic for money (with which to stay afloat) and probably an accompanying collapse in the banking system (as bad debts swamped the nation). The resultant chaos would almost surely be reflected in sky-high prices for real money, unmortgaged money–gold.

Although nothing is guaranteed in the world of investing and survival, I continue to believe that subscribers must own some gold. Many (I hope most) of my subscribers do hold up to 15% of their total assets in gold coins. Others may have sold their gold on the recent second phase explosion to the 850 level. I have no way of knowing. But I have some new ideas on gold, and I'm going to present them now.

Gold has been holding in the 470 to 550 area for a few months. I discussed this emerging pattern at length in recent Letters. And the truth is that I had felt that gold was due for one more break to the downside–BUT now I am beginning to change my mind. The recent action of gold has been impressive, and I NOW BELIEVE THAT TIME IS RUNNING OUT FOR A FINAL DOWNSIDE BREAK IN GOLD' This is a ***new stance*** for me on gold.



I am beginning to turn bullish on gold again for the following reasons.

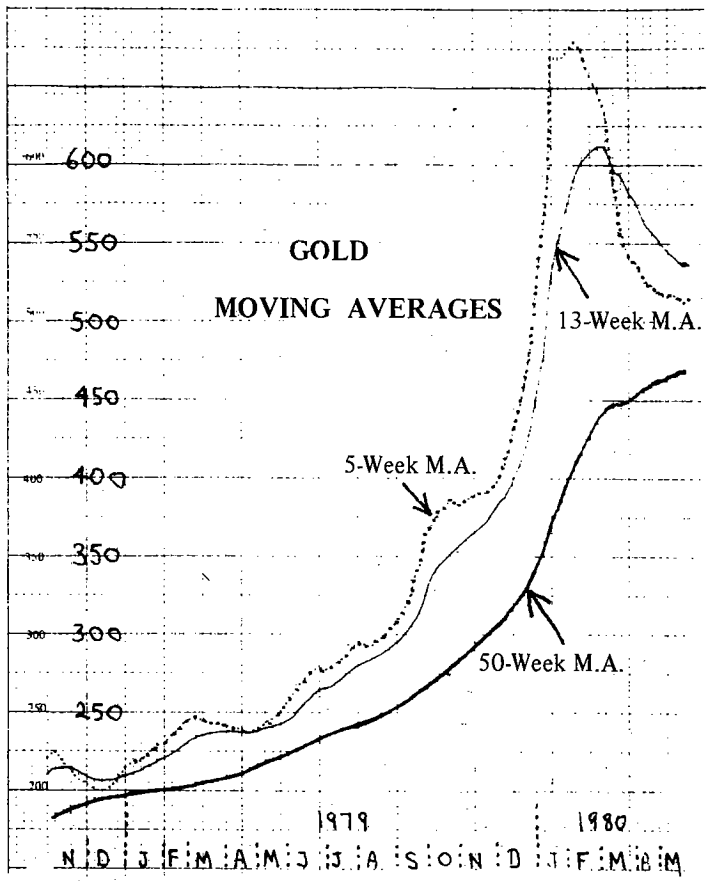
(1) Gold has held up remarkably well in the face of the extraordinary collapse in silver. Currently, silver shows signs of bottoming out and gathering a bit of strength and this could help gold.

(2) Gold has pushed out to the apex of its two-month triangle and weakness has ***not*** set in. This is a technical plus (see point & figure chart).

(3) My 50-week (exponential) moving average of gold (see chart) is at 470 and it is STILL RISING. It is still rising because gold never broke below the 50-week MA. Thus the rising 50-week MA (I call this the primary trend line) continues to present a long-term bullish profile for gold, and the longer that gold holds above the still-bullish 50-week MA, the nearer we are to the next major advance.

The intermediate or 13-week MA of gold now stands at 533, well above the 50-week MA. If spot gold holds above 533 this MA will turn up too. But the fact that the 13-week MA continues to hold above the 50-week MA holds long-term bullish connotations.

The sensitive 5-week MA is now at 517, and it turned UP last week. It turned up when gold spurted above 520 to the 540's area. If gold can hold above 540 for a few weeks, the 5-week MA will rise and cross above the 13-week MA. If it can do this, we will have a bullish signal on the basis of the MA studies. But as



long as gold holds above the level of both the 5-week and 13-week MA's (in other words, above 533) we are presented with bullish possibilities.

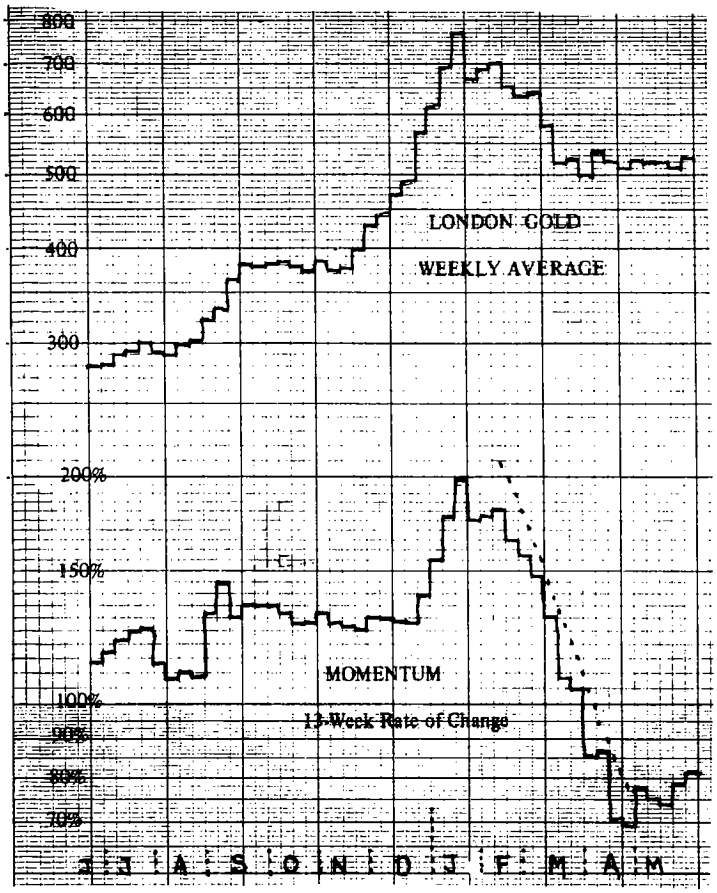
(4)The gold stocks did not act during the 1980 decline the way they did during the 1974 debacle. This time they tended to hold very well. Now they are looking bullish (despite the many troubles, the increasing troubles in So.Africa). The shares, in other words, show good relative strength against the metal. This is a good sign for gold in general.

(5) My ratio of gold bullion to common stocks (i.e., gold divided by the NYSE Composite Index) appears to be ***bottoming out***. This ratio has dropped for 5 consecutive months, indicating that the relative strength of common stocks on the NYSE has been superior to gold. Now we are close to a reversal signal, which, if it occurs, would indicate that gold is about to outperform common stocks. This would be a strong bullish signal for gold.

(6) I keep a momentum index, which is a 13-week rate of change index, for gold. This index hit an extreme low of 69% on the week of April 18. Last week the average price for gold hit a 6-week high of 520, and the momentum index rose to a 5-week high of 82%. As you can see on the chart, the momentum index has now reversed to the upside following its 1980 slump. This is bullish for gold.

(7) From a fundamental standpoint, it is now all too clear that the Fed will do anything to ward off the effects of unemployment and dis-inflation. The cost of attempting to turn this nation's sagging economy around will be huge in terms of money spent and in terms of inflation and in terms of deficits. But the Fed is willing to try, nevertheless.

(8) On May 28 the discount rate was lowered a full 1%. A declining discount rate has, in the past, been the signal for gold to



decline (since a dropping discount rate is a function of recession and presumably less inflation). But gold ignored the latest drop in the discount rate and moved higher. Gold is obviously moving to the beat of a different drum.

(9) Perhaps most important of all, the gold market may now sense what I have written in the "X Marks the Spot" section of this Letter. If so, it's anyone's guess what will happen to gold as the Russians start moving on the Mideast. But I would think that gold would "take off" as the Arabs and the world panic out of dollars and into gold.

(10) Gold is the ultimate financial "insurance policy," and, in my opinion, the US and the world is moving ever-nearer to the point where insurance is going to be needed. I base this on the build-up of debt, on the build-up of Russian power, on the unravelling of the Western Alliance, and on the instability of the OPEC oil situation. But there is another "powder keg" area and that one is the area of debt which Western bankers (in their insatiable greed) have lent to the so-called "Less Developed Countries." Total debt of these LDC's in the year 1971 was $64 billion. By 1975 these LDC debts had climbed to $160 billion. Now in 1980 the total debts are $325 billion! As the debts of these nations grow, repayment burden grows heavier. For instance, Brazil's external debt is now $54 billion. Servicing this debt takes 36% of Brazil's total export earnings. Turkey has $23 billion in debt, Argentina has $27 billion in debt, Yugoslavia has $13.7 billion of debt, etc.

I've asked myself whether the international banking system could withstand a default by one of these nations. I don't know the answer. I do know that with rising oil prices and declining world business, someone is going to default. It's only a matter of time. My own guess is that we're going to see the first default during 1980-81. If so, our so-called international bankers will have their hot little hands full. Needless to say, I do not recommend bank certificates of deposit as a place for my subscribers to keep their money in 1980.

Conclusion: If you do not hold any gold, move. I would hold at least 15% of assets in gold (even if you don't like gold!). If you have a feel for gold as most of my subscribers do now, up your holdings to 20%. If spot London gold moves above 560, increase your gold holdings to 20% to 30% of assets. Gold above 560 will be the market's way of telling us that the second phase lows have been seen. If so, we will be in the early stages, the very early stages of the final third phase of the gold bull market. In that case, I expect the record high of 850 to be far surpassed–in due time.

As to what to buy, I recommend the Canadian Maple Leaf coin, which is one ounce of pure gold and now sells at a very small premium over actual gold content.

LATE NOTES: The PTI closed on May 30 at 1172, a new recovery high since the March low. The Dow Industrials are now looking tired and did not confirm the new high in the PTI. This may be the first HINT of trouble, but as I've said many times before, there isn't going to be any major decline until the PTI starts on a well defined downward path. So far, the PTI has been resisting decline. My main interest in this area, however, is in the new action in gold.

I'm off to New York for a few days, where I'll see the Picasso exhibition. One subscriber writes to ask how I can go to see the works of a "Communist viper," but when it comes to art and genius, it exists in all countries and politics has nothing to do with it. Besides seeing the Picasso exhibition, I want to take a full day and just walk around my old haunts in the City (from Broadway to Fifth Avenue, from the West 70's to the East 80's, from Canal Street to the edge of Harlem. This is something I haven't done for years, and I miss walking those NY streets. Then it's to Montreal and the NCMR Conference, and I hope to see a lot of old friends there.

BROOM-HILDA
I'VE DECIDED TO OPEN MY OWN SMALL BUSINESS. I WILL REPAIR BROKEN SHOELACES!
G. BLIZZARD SHOELACE REPAIR
WHAT HAPPENED? AS I SAID THAT THE SKY WENT DARK!
GOVERNMENT INSPECTORS!
RUSSELL MYER

At left is our humorous piece for this issue. Of course, if you happen to be in your own business you may not think this is humorous.

NEXT MAILING: June 18th